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A Time For Optimism?

The Federal Reserve Board announced this month that they would not raise interest rates at this time. Media outlets we monitor were caught a bit off guard by the announcement - a consensus had formed that it was time for rates to rise. But with the announcement of no change their focus is again on economic weakness. The common thought is that the economy must not be growing as expected if the Fed left rates unchanged.

While we certainly understand this view, we believe that it is not so clear cut. For some time, we have been comfortable with the concept that the economy is working like a plow horse rather than a thoroughbred horse. It is true that the economic recovery from the Great Recession has not burned down the doors with accelerating the GDP growth. This extended period of tepid growth has been feeding the fires of pessimism we have seen building in recent months. GDP has been positive for the past five years, except for Q1 2014 when GDP went negative from a brutal winter. While some sectors still lag, other sectors have seen above line growth for some time. As investors, we can choose where to place our assets to best maximize opportunities while looking to limit downside volatility.

While the financial media does a great job focusing on the negative, we would like to take a moment to feature a few positive stories that highlight areas of unique growth and ingenuity. We will focus on stories within three sectors: Manufacturing, Transportation, and Agriculture. These are just a few examples of the sometimes hidden undercurrent of positive news.

When most people hear "Alcoa" they think of an old and stodgy metal company. However the 127 year old company is revolutionizing the way aluminum is made and they might just turn the auto making industry upside down. Recently Ford introduced an all-aluminum body version of the popular F150 pickup truck. This new, lighter, body maintains the strength the F150 is known for but provides significantly higher gas mileage and is 15% lighter.

This breakthrough was made possible by Alcoa's change in their production methods. Previously producing aluminum took almost 20 days start to finish and required a massive facility. The new "micromill" used by Alcoa can produce aluminum in 20 minutes and needs less than 25% the

amount of space. The new aluminum is stronger and more formable, making it a perfect fit for auto making. Cheaper and stronger aluminum could be the answer in the search for better fuel efficiency. We anticipate seeing more companies move towards a higher percentage of aluminum parts.

In transportation - Uber and Lyft connect users through an app on their smartphones with individual drivers who are able and willing to drive you to the destination of your choice. Drivers are reviewed by riders so that users can select highly rated drivers in their area. All payment transactions are done through the app so cash is no longer needed. While some claim these services are only used by millennials, trade publication Certify Travel and Expense Made Easy claims that business travelers are using Uber more than taxis. This new transportation idea is generally more accessible and provides lower fares. Additional services are being added all the time such as meal deliveries, groceries, and a service that is similar to a courier service.

Uber and other ride share programs will likely continue to grow in scope. In doing so, they will help end the crony capitalism system where local government controlled all aspects of transportation. We see this as a positive.

When looking at agriculture, we are reminded of the technology we first saw at EPCOT in Disneyworld - vertical farming. This method of agriculture, where crops are grown indoors on many levels of shelves, generally uses hydroponic or aeroponic technology. These techniques reduce the amount of water needed and almost completely eliminate the need for pesticides. Growing food in this way reduces the number of variables that can negatively impact yield. While not yet widespread, some companies are starting to make it a priority. A group of supermarkets in the Chicagoland area worked together to fund a vertical farming system in New Buffalo, Michigan. These markets now have more food to sell, grown in a controllable and eco-friendly way that is grown at lower costs.

In summary, both sides of the political debate use arguments that fit their versions of reality. However, both sides are fueling the overwhelming pessimism we see daily. When we remember that politics are not economics, and look only at the economics, we see an economy getting stronger driven by innovation and work ethic. While it may not be as abundant as we'd like, there are things to be optimistic about.

What Do We Expect Ahead?

The recent sharp decline in stock prices is a reflection of the state of pessimism. With all the news of gloom, investors are acting like a repeat of 2008 is eminent. Our industry has several methods of measuring optimism or pessimism among advisors and investors. We have subscribed to one provider of sentiment data for over 20 years. They measure "bullishness" or "bearishness" among market advisors. Currently, their readings show pessimism equal to or greater than levels measured in late 2008. We think this pessimism is overdone. In 2008, real estate prices had been cratering for two years. Bank solvency was so in question, the federal government needed to bail them out. The economy had been in recession for almost one year.

We don't see any of these fundamental problems in today's economy. Home prices have been rising for several years and jobs are available for those who have the skills required and want to work.

Banking as an industry is profitable. One of the proxies for investor fears has been the price of gold. The price has declined almost 40% since 2011.

Accordingly, we view today's overt pessimism as a force that put America's greatest businesses on sale. We think stock prices should soon find their bottom soon and a new up cycle to begin. This has been the history of our economy. Our economy has been and still is the strongest in the world. America has the highest standard of living in Earth. People still want to come to the Land of Opportunity.

Portfolios

The stock market measured by the Standard and Poor's 500 Stock Index (S&P 500) has not had a correction of more than 10% since the summer of 2011. Through September 15th, this year has seen the S&P 500 decline of 14.7% from its May 20th high of 2,134 to its August 24th low of 1820. As the market worked lower, volatility increased sharply. In many weeks, the markets rose and fell several hundred points in a day. Naturally, a correction (-10% or more) brings into focus the question of whether we have entered a bear market (-20% or more). This raises investor anxiety and fuels pessimism

For portfolios managed by discretion, our answer has been to raise cash. We began raising cash in June, and accelerated this process in July and early August. Raising cash accomplishes two important tasks. First, raising cash limits the amount of current downside volatility, keeping portfolios more steady in value than staying fully invested. But raising cash also allows us to have fresh ammunition for buying when markets settle down and begin its next up leg.

This down cycle is the seventh such event we have managed assets through. If we have seen anything in the previous six declines it's that the declines have been temporary, and the advances more permanent.

Enclosures

Enclosure #1 is a pie chart put together by First Trust Advisors. The chart details the percentage of global GDP produced by each country listed. We find this to be very interesting.

Enclosure #2 is provided from Putnam Investments. It gives a look into how markets have performed after sharp corrections and bear markets. The format is to look at specific events in the news which headline each decline. We think the most valuable part of this piece is to scan the column marked "1 year later". There are 18 entries of news dating back to the fall of France in 1940 at the beginning of WWII. Of the 18 incidences cited, the market was higher 1 year later in 16 of these occasions, which is 90%. Looking deeper, we see that the market appreciated at least 20% one year after the event in 10 of the 18 cited years. We believe that this piece of history let's investors see that while we are focused on the present, we should be looking to the near future.

Enclosure #3 is the September 21, 2015 comments from Brian Wesbury, Chief Economist for First Trust Advisors. In this commentary, Brian questions the need for all the media hype around the Federal Reserve Board and their seemingly never ending soap opera about its decisions to raise or

not raise interest rates. His point here is that raising rates or not should not affect the economy as much as the media wants us all to believe.

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There is an inverse relationship between interest rate movements and bond prices. Generally, when interest rates rise, bond prices fall and when interest rates fall, bond prices rise.

Gross Domestic Product (GDP) is the annual market value of all goods and services produced domestically by the US.

U.S. Treasury Securities are guaranteed by the U.S. government and, if held to maturity, offer a fixed rate of return and guaranteed principal value.

While interest on municipal bonds is generally exempt from federal income tax, it may be subject to the federal alternative minimum tax, or state or local taxes. Municipal bond investments may involve market risk, credit risk, and interest rate risk if sold prior to maturity.

Companies engaged in business related to a specific sector are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification.

Commodities are generally considered speculative because of the significant potential for investment loss. Commodities are volatile investments and should only form a small part of a diversified portfolio. There may be sharp price fluctuations even during periods when prices overall are rising.

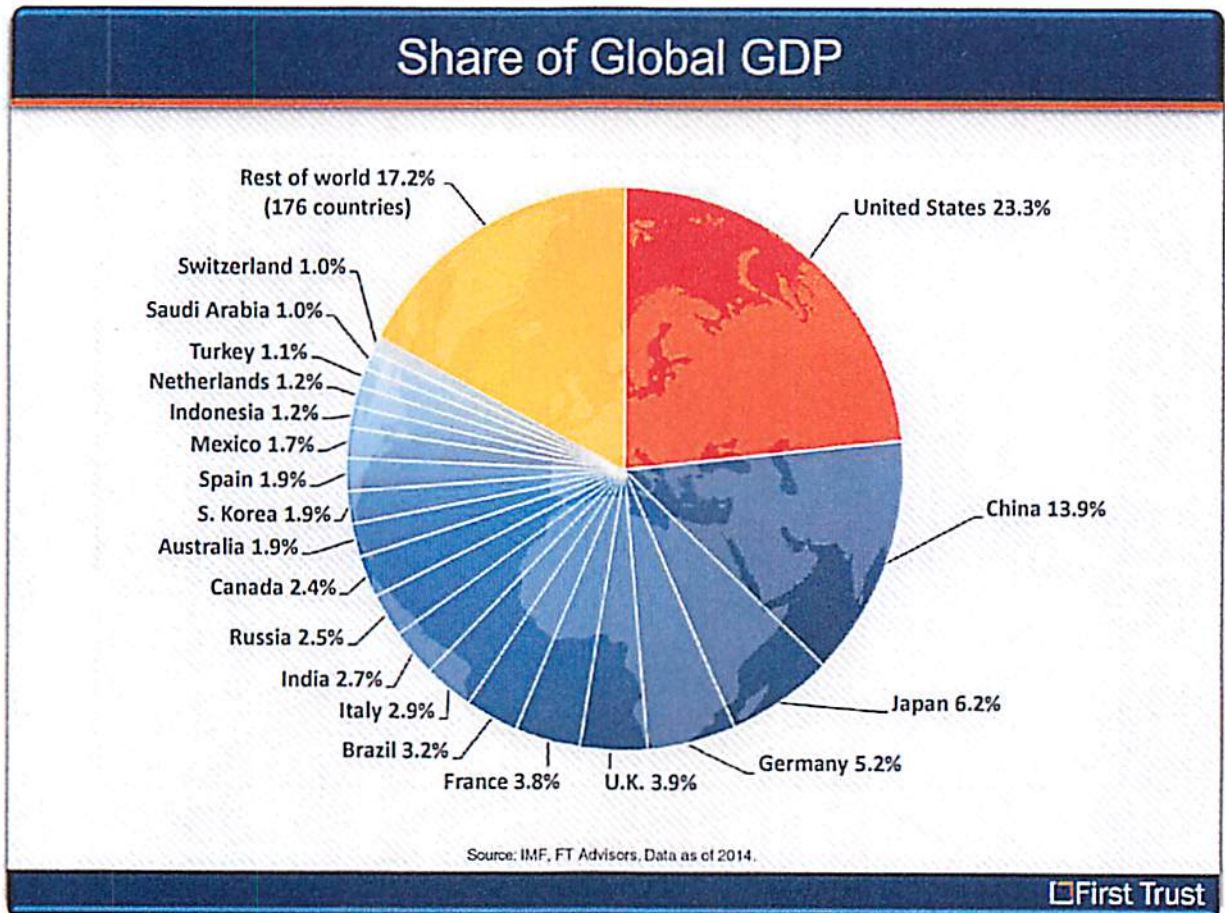
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This chart, using data from the International Monetary Fund (IMF), shows the share of global GDP produced by various countries. For all the scare stories about China, this chart shows that China's share of global GDP is only 60% of the United States' share. Routinely we hear stories of how powerful the Eurozone is. If you add up the entire Eurozone's share of global GDP it doesn't match that of the United States' share.

These numbers can, and will, change over time. Demographic studies, focusing on population growth, show that countries like Japan may have a worker shortage in the near future. This will likely reduce Japan's share as well.

Markets recover from crises

Staying invested lets you benefit from a rebound

Though unsettling, a crisis does not spell the end for markets or investment strategies. History has shown that markets bounce back, and that staying invested through volatile episodes is often the right decision for pursuing long-term financial goals.

CRISIS AND RECOVERY: HOW THE S&P 500 INDEX PERFORMED DURING AND AFTER HISTORIC EVENTS

Event	Event reaction dates	Percent of gain/loss during event	S&P 500 percentage of gain/loss after last reaction date			
			1 month later	1 year later	5 years later	10 years later
Fall of France	5/09/40 – 6/22/40	-16.9%	0.7%	5.0%	15.7%	13.2%
Attack on Pearl Harbor	12/06/41 – 12/10/41	-7.5	2.1	15.8	18.0	17.1
Outbreak of Korean War	6/23/50 – 7/13/50	-12.2	10.2	42.2	27.7	18.5
Eisenhower heart attack	9/23/55 – 9/26/55	-6.6	-0.5	11.9	8.4	11.5
Cuban Missile Crisis	8/23/62 – 10/23/62	-9.9	15.5	41.1	15.8	11.1
Kennedy assassination	11/21/63 – 11/22/63	-2.8	7.0	27.8	12.4	7.0
U.S. attacks Cambodia	4/29/70 – 5/26/70	-15.0	6.4	49.0	9.3	9.3
Nixon resigns	8/09/74 – 8/29/74	-13.4	-6.8	30.2	14.6	14.6
U.S.S.R. invades Afghanistan	12/24/79 – 1/03/80	-1.8	9.9	36.5	15.0	18.0
U.S. invades Grenada	10/24/83 – 11/07/83	-2.1	2.8	9.4	15.9	15.0
1987 stock market crash	10/02/87 – 10/19/87	-31.5	7.1	27.7	17.0	18.9
U.S. invades Panama	12/15/89 – 12/20/89	-2.1	-0.9	-0.2	9.3	18.2
Gorbachev coup	8/16/91 – 8/19/91	-2.3	3.2	14.5	15.2	14.3
Gulf War ultimatum	12/24/90 – 1/16/91	-4.0	17.2	36.6	17.3	18.0
Collapse of Long-Term Capital Management	8/28/98 – 9/09/98	-2.0	-2.0	35.8	1.8	3.7
September 11 terrorist attacks	9/10/01 – 9/21/01	-11.6	11.3	-11.1	8.3	3.9
U.S. invades Iraq	3/18/03 – 3/31/03	-2.1	8.2	35.1	11.3	8.5
Collapse of Lehman Brothers	9/05/08 – 11/20/08	-39.1	18.3	48.8	21.5	—
Mean gain/loss		-10.2	6.1	25.3	14.1	13.0
Median gain/loss		-7.1	6.7	29.0	15.1	14.3

Historical references do not assume that any prior market behavior will be duplicated. Past performance does not indicate future results.

There are risks associated with mutual fund investing including the possibility that share prices will decline. Since investment return and principal value will fluctuate, shares when redeemed may be worth more or less than their original cost. Performance of Putnam funds will differ.

The S&P 500 Index is an unmanaged index of common stock performance. You cannot invest directly in an index. Indexes are unmanaged and used as a broad measure of market performance.

The pattern of crisis and recovery

All too often, a crisis can lead to fear as public perceptions become overly pessimistic. Financial markets that are usually rational can behave irrationally. But the U.S. stock market has proven remarkably resilient; it routinely has recovered from short-term crisis events to move higher over longer time periods.

The graph below shows a hypothetical investment in the S&P 500 Index, which represents some of the largest companies in the U.S. stock market from across all sectors

of the economy. In spite of recessions, wars, and other crises, the annualized return over the past 74 years was 11.39%.

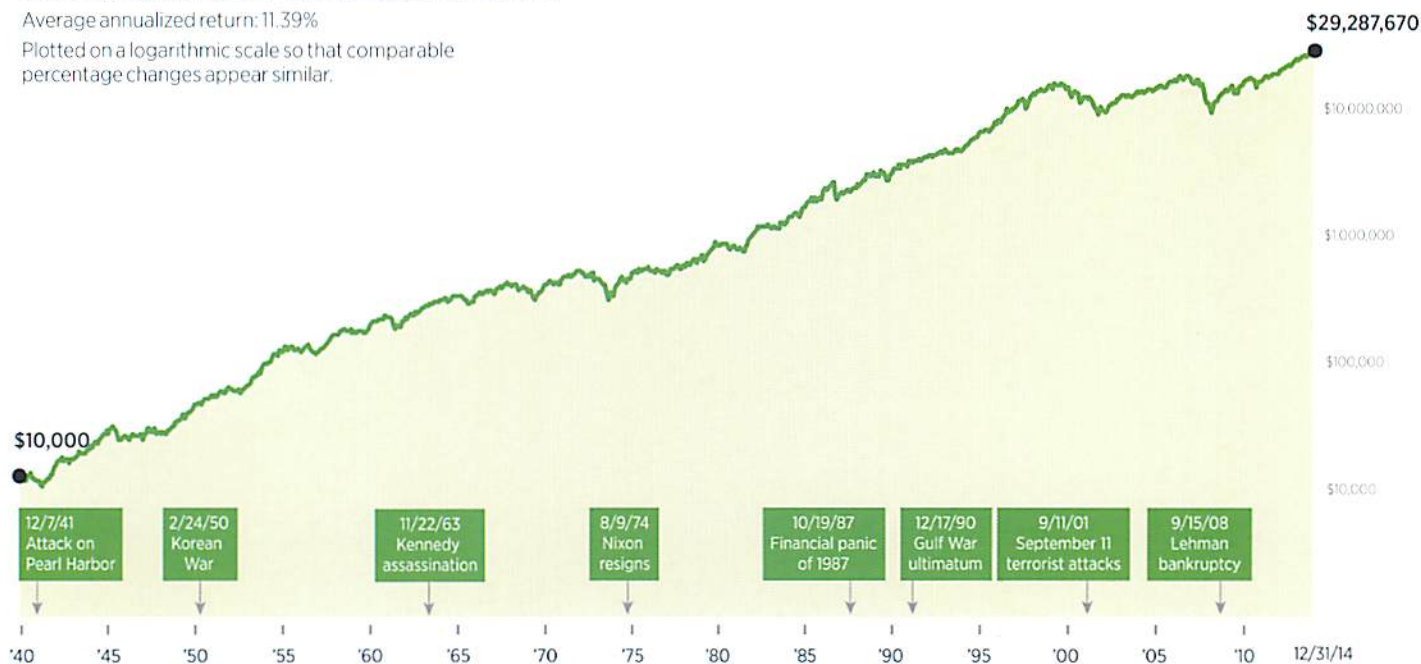
With this historical perspective, investors can align their expectations with the market's long-term averages rather than its short-term ups and downs. History has shown that markets have recovered, and often over relatively short time periods. By staying invested during crises — or by investing during a crisis to take advantage of stock market valuations — investors can keep their portfolios on track in pursuit of their long-term goals.

Stocks have overcome short-term events to move higher

Growth of \$10,000 in the S&P 500 Index (12/31/40–12/31/14)

Average annualized return: 11.39%

Plotted on a logarithmic scale so that comparable percentage changes appear similar.



This graph represents a hypothetical \$10,000 investment in the S&P 500 Index, an unmanaged index of common stock performance. You cannot invest directly in an index. Indexes do not have sales charges and do not represent the performance of any Putnam fund or product. Past performance does not indicate future results, and prior markets may not be duplicated. Systematic or continued investing does not assure a profit or protect against loss. You should consider your ability to continue investing during periods of low price levels. The time horizon shown here is longer than that of most investors.

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 **First Trust**

Monday Morning **OUTLOOK**

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The Uber-Dove vs Black Swans

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You couldn't have missed it. Only stages full of GOP presidential candidates or the Super Bowl have ever had more media attention. Yes, we are talking about the Federal Reserve's thundering announcement on Thursday – of nothing. The Fed decided to keep interest rates at zero, for at least the next few months, after holding them near zero for over six years.

In one sense, this is a non-event. We have been in this same spot for quite some time. In spite of three rounds (and \$3.6 trillion) of Quantitative Easing and very low interest rates, the US economy remains in a Plow Horse, low-inflation recovery. Japan has been doing QE for decades and its economy isn't growing, while the European economy is weak and its stock markets are down since QE II started back in March.

In other words, all the gnashing of teeth about the Fed seems like a huge waste of time. This is especially true when we consider the fact that raising interest rates wouldn't be actually changing monetary policy at all.

Over time, investors have been confused (as happens during a street-side shell game) about what monetary policy really is and how it works. Many people have come to believe the transmission mechanism of Fed policy is interest rates, but this isn't true and never has been.

Monetary policy works as the Fed adds or subtracts reserves from the banking system, and by adding or subtracting reserves they are able to increase or decrease "aggregate demand" or what we can think of as "total spending."

When a counterfeiter puts more money into a neighborhood, the economy gets a temporary pop. When the FBI takes the money away, it slumps. The reason QE never worked as advertised is that when the Fed "printed money" in exchange for bonds, the banks that sold the Fed the bonds held the money in "excess reserves." The neighborhood never spent the counterfeiter's money. The Fed's balance sheet has grown 26% annualized over the past seven years, but the M2 measure of money (total deposits in all banks) has grown only 6.6% per year.

All those excess reserves are still out there, un-multiplied. That's why all the crazy forecasts of hyper-inflation, \$5,000 gold and a collapsing dollar never came true.

And here's the rub. The Fed does not intend to reduce those reserves anytime soon, and would not have reduced

them by one dime last week even if they had raised interest rates.

Throughout history, when the Fed wanted the federal funds rate to rise, it withdrew reserves from the banking system by selling bonds to banks. Yes, interest rates would rise because liquidity was withdrawn, but the impact on the economy was from the slowdown in money growth, not the rise in rates.

If the Fed had hiked rates last week, reserves would have stayed exactly the same. All the Fed would have done is announce that it was paying more to banks on excess reserves, as an enticement not to lend them. Every dollar of excess reserves would have remained in the system. A rate hike would not rip away the punch bowl, in fact the punch bowl would still be overflowing with excess reserves waiting for someone to slurp them up.

In the past, when the Fed has raised rates, banks did not hold any significant amount of excess reserves. So higher short-term rates meant it was tougher for banks to acquire the funds they wanted to lend. Now, many banks are filled to the brim with excess reserves and are barely trading federal funds among each other.

Sometimes they say, "follow the money," but we suggest "follow the profits" to understand Fed actions that confuse you. So let's do it. Right now the Fed owns \$4.2 trillion in bonds which pay whatever they pay, while it gives banks ¼% on reserves. The "spread" generated a profit last year of roughly \$100 billion, which the Fed then turned over to the Treasury. If the Fed would have increased what it paid banks on reserves to ½%, this would have reduced the Treasury cash inflow by about \$7 billion over the next year and this money would have gone to banks. In other words, the Fed and Treasury have an incentive to keep rates very low so that their profits stay high.

The biggest problem the US has now with its economic management team (including the Fed) is that it has spread the narrative that only QE and other government programs saved the economy during the crisis. We do not believe this one iota. In fact, we believe government rules forced Fannie Mae and Freddie Mac to buy sub-prime mortgage bonds. That created the crisis. Yet, it serves government interests to blame it on banks and the private sector.

This has helped create a cottage industry of Black-Swan birdwatchers. Instead of looking for an answer, they just claim 2008 was like a severe earthquake that was

unpredictable. The pessimists create fear as they find a new Black Swan every week, which, for investors who believe this stuff, is terrifying. But they have also enhanced the narrative to include the idea that if the Fed raises rates, the only support for growth will be ripped away.

This is also a misconception. Does anyone with common sense really believe that QE and zero percent rates invented the Apple Watch, or increased the efficiency of fracking, or created Uber, vertical farming, 3-D printing, the cure for Hep-C, or any of the other massively wonderful new technologies and inventions we have seen put in place in the past six years?

The Fed does not cause real, long-term wealth creation. It never has and it never will. It either accommodates growth by printing the right amount of money, therefore avoiding deflation, or it prints too much money, which won't stop growth but will cause inflation. It can cause harm by allowing the money supply to collapse, but once mark-to-market accounting was fixed in March 2009, that possibility evaporated.

There is an argument running around that says: If the Fed wouldn't, or couldn't, raise interest rates, then there

must really be something wrong with the economy. This argument is sophomoric. It gives the Fed some kind of supreme, omnipotent power of knowledge that no one else has. But, other than private bank information and probably some foreign government secrets, the Fed has access to the same data that we do and none of it suggests the US economy needs zero percent interest rates. Initial claims have been below 300,000 for 29 straight weeks. And anyone who claims 173,000 new jobs is a clear sign of economic problems, especially in August (which is so often revised higher), is spinning the data.

Yes, China's growth has slowed to 7%, from 10.6%. So what? Japan collapsed in 1990 when it was the #2 economy in the world, and the next ten years were fabulous for US investors.

All in all, what is really going on is that many people think there are Black Swans flying around everywhere, and that the only way to protect the US economy from them is with an Uber-Dove. It looks like Janet Yellen has decided she is that Uber-Dove, despite a real lack of evidence that Black Swans exist or Fed policy has protected the economy from them in the past six years.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-21 / 9:00 am	Existing Home Sales – Aug	5.500 Mil	5.520 Mil	5.310 Mil	5.590 Mil
9-24 / 7:30 am	Initial Claims – Sep 19	273K	270K		264K
7:30 am	Durable Goods – Aug	-2.3%	-3.3%		+2.2%
7:30 am	Durable Goods (Ex-Trans) – Aug	+0.1%	+0.3%		+0.4%
9:00 am	New Home Sales – Aug	0.515 Mil	0.515 Mil		0.507 Mil
9-25 / 7:30 am	Q2 GDP Final Report	3.7%	3.7%		3.7%
7:30 am	Q2 GDP Chain Price Index	2.1%	2.1%		2.1%
9:00 am	U. Mich Consumer Sentiment- Sep	86.5	86.0		85.7